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No. 33

IN THE

Supreme Court of The United States

OCTOBER TERM, 1958

T. V. WILLIAMS, as State Revenue Commissioner,
Petitioner,

v.

STOCKHAM VALVES & FITTINGS, INC.,
Respondent.

SUPPLEMENTAL BRIEF FOR RESPONDENT

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SUPPLEMENTAL BRIEF FOR RESPONDENT

Needless to say, the questions presented by the instant case are of great importance to all manufacturing companies which do an interstate business and to all of the states. Not only counsel for the respondent, but represen-

tatives of many companies and trade associations, hav carefully examined the professional literature, both in th field of law and in the field of economics, to determine wha research has been done on the effect that state income taxe would have on interstate commerce under the circumstance of this case. Apparently no study of this problem has eve been published.

A number of these companies and trade associations, dis turbed by the increasing number of states which are threat ening to impose similar income taxes on foreign corpora tions, believed that a practical investigation of the proble would point the way to its solution by the judicial and legis lative branches of the federal and state governments. Ac cordingly, they made available a grant to be used by a outstanding economist, Dr. Paul Studenski, in undertakin such an investigation. An article describing his work wa just completed last week and is scheduled to appear in th November issue of The Harvard Business Review. By per mission of the Review and the authors, we are printing th article in the Appendix to this brief.

The study described in this article was conducted durin the winter and spring of 1958. In the course of the study interviews were held in various states with many compan executives, tax officials, tax accounting firms and scholar A comprehensive questionnaire was used, extensive cor respondence was carried on, and a thorough search wa made through the existing literature.

The article, entitled "A New Threat in State Busines Taxation," outlines the development of state income ta laws and describes the practices which have been followe in the past. It then points to the recent attempts by certai states to extend the application of their corporate incom taxes to companies which merely solicit orders in the stat Finally, based on data which the authors have collected,

analyzes the rationale and potential economic effects of these innovations.

Dr. Paul Studenski is Professor Emeritus of Economics at New York University and Senior Fiscal Consultant to the New York State Special Legislative Committee on the Revision and Simplification of the Constitution (otherwise known as the Rockefeller Committee). He has been on the faculty of New York University since 1927, having been a professor since 1935. In 1955-57, he was Director of the Albany Graduate Program in Public Administration. Over the past forty or more years he has served as fiscal consultant or research director to numerous federal, state and municipal agencies, including the New York State Division of the Budget, the New York State Commission on the Revision of the Tax Laws, the Bureau of the Budget, the New York City Mayor's Committee on Finance, the U. S. Social Security Board, the Board of Economic Welfare, the Temporary National Economic Committee of the United States Congress, and many others. He is the author of several books, including "Taxation and Public Policy," "Government of Metropolitan Areas," "Chapters in Public Finance," "Variations in State Fiscal Capacities," "Financial History of the United States" (with H. E. Kroos), and "The Income of Nations" (scheduled to appear this month). He is the author of numerous articles on public finance in professional and scientific journals.

Dr. Studenski's co-author, Dr. Gerald J. Glasser, is Assistant Professor of Economics at New York University. He is the author of several articles in the field of economics and statistics and has served as consultant to several governmental agencies.

"A New Threat in State Business Taxation," by Dr. Paul Studenski and Dr. Gerald J. Glasser, is a penetrating study of the impact of taxes such as Georgia asks this Court to uphold. The authors' conclusion that such taxes

will amount to a tremendous burden on commerce is inescapable.

Respectfully submitted,

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October 13, 1958

APPENDIX

Any company that makes sales in more than one state faces a . . .

NEW THREAT IN STATE BUSINESS TAXATION

From the Havard Business Review, November 1958

By Paul Studenski and Gerald J. Glasser

State taxes on corporate net income have always posed difficult legal, economic, administrative, and accounting problems, both for the authorities imposing them and for the corporations paying them. These difficulties threaten to become even greater if certain alterations in the concepts of these taxes recently introduced in some states are fully enforced, adopted by other states, and allowed by the courts to prevail. We refer to the application of such taxes to out-of-state corporations which maintain no factories, warehouses, stores, or other permanent establishments in the tax-levying state, but merely solicit orders and ship goods to customers in it.

EMERGENCE OF PROBLEM

The difficulties that have attended the application and administration of corporate income taxes stem largely from the fact that most corporations of any size operate properties, maintain regular business establishments, and solicit orders in more than one state. It is not always clear what portion of their income, if any, derives from their operations within a particular state. Not only is a corporation likely to be taxed on its net income by several states, but it

AUTHOR'S NOTE: This article presents the results of a study prepared under a grant made available by a group of industries and trade associations to the senior author, who, in turn, arranged for Dr. Glasser to assist him in the work. Acknowledgment is due to the many company executives, state tax officials, accountants, and scholars who contributed factual information.

may be taxed by a state which really has no right to tax i
Moreover, it may be unfairly subjected to a double or trip
burden on the same portion of its net income.

Under the due process clause of the federal constitutio
a state is permitted to tax only those persons, propertie
and transactions that have some connection with it. B
what constitutes a sufficient connection in the case of co
porations doing interstate business is the crucial questio
In addition, there is always the possibility of a state a
plying the tax to a corporation in such a way as to interfe
with interstate commerce in violation of the federal const
tution. Thus, it is easy to see how the application of corp
rate net income taxes can give rise to litigation that mig
begin in the state courts but would be settled definitive
only when it reached the Supreme Court.

In its jurisdictional and allocational aspects, the sta
corporate income tax is more complicated than almost ar
other state business tax. Were it not for the fact that und
many circumstances it is more equitable and also econor
ically sounder than any of the other state business taxe
it would never have been as widely accepted by state go
ernments and taxpayers as it has been.

Traditional Concept

Until recently the state corporate income tax has bee
applied only to corporations maintaining some permanen
establishment in the state, such as a manufacturing plan
a warehouse, a wholesale or retail outlet, or an office th
accepts orders for execution. The tax has been applied,
other words, to corporations employing capital and labo
in the state in a regular way, thus constituting a more
less permanent and integral part of the state's economy

The state in which the corporations carry on their pr
ductive activities is vitally concerned with their growth ar

prosperity because these companies are essential factors in the over-all growth and prosperity of the state's economy. For this reason, the state renders them a variety of protective and economic services which facilitate their operations and help them to earn a profit. It has, therefore, a rightful claim for a share of the net income of these corporations.

Until the end of World War II no state applied its corporate income tax to out-of-state corporations that merely solicited orders in the state or shipped goods to customers there in fulfillment of orders relayed to the home office. Such corporations were not considered to be a part of the state's economy or the recipients of any benefits that would entitle the state to tax them. Admittedly, the state maintains a market in which the out-of-state corporations sell their goods, but it does so primarily for the benefit of its citizens and not for that of these corporations. It is not interested in seeing that out-of-state corporations earn a net income from their sales; this concern, it is felt, properly belongs to the home states of these corporations.

Until recently, too, the states using the corporate income tax applied it under allocation formulas emphasizing location of property, maintenance of payrolls, and site of the administrative offices in which orders were received for execution. These formulas were comparatively fair and did not differ in principle too much from state to state. By adhering to these simple rules the states managed to keep unfair multiple taxation of corporate net income to a minimum and to administer taxes with a reasonable degree of efficiency and without excessive harassment of their corporate taxpayers.

New Formulas

Since the end of World War II, however, several states have altered their statutes or have reinterpreted them to

extend the application of their corporate income taxes to out-of-state corporations that neither own and operate properties there nor maintain any permanent establishments authoritatively representing the company. This has been part of a trend toward the extension of state taxation into the field of interstate commerce.[1] At the same time, quite a few states have altered their existing allocation formulas by substituting sales-by-destination or sales-by-site-of-solicitation criteria for the more conventional receipts factor or else by modifying some of the other factors. The result is that allocation formulas have become much more diversified, and the possibilities for unfair double or multiple taxation of corporations have been greatly increased.

This extension of the jurisdictional base of the states' corporation income taxes, combined with the alterations in their allocation formulas, threatens to make corporations throughout the country subject to taxation on their net income by many more states. It promises to make these taxes increasingly burdensome and more difficult to administer and comply with. Worst of all, it may cause them to become serious impediments to interstate commerce.

Cases Pending

Some of the corporations suddenly presented with an income tax assessment in states where they have merely been selling goods have protested and have applied to the courts for a review of the constitutionality of the assessments. Three such cases involving the same issue, although in a somewhat different context, after having been variously ruled on by the courts of their own states, have reached the

[1] See the following articles by Edward Roesken in *Taxes:* "State Taxation of Foreign Corporations," September 1950, p. 819; "The Impact of the Spector Decision," July 1951, p. 523; "Recent State Tax Trends," January 1952, p. 9; and "State Tax Trends," February 1955, p. 131.

Supreme Court. At the moment of this writing two are scheduled to be heard shortly and the third has been petitioned for a review. Similar cases originating in still other states are now pending in the state courts and may have to go to the Supreme Court for final adjudication.

The three cases being brought before the Supreme Court are *Williams* v. *Stockham Valves & Fittings, Inc.*, involving Georgia's corporate net income tax; *State of Minnesota* v. *Northwestern States Portland Cement Co.*, involving Minnesota's tax; and *Brown-Forman Distillers Corporation* v. *Collector of Revenue*, involving Louisiana's tax. The circumstances involved in these cases are as follows:

Stockham Valves & Fittings, Inc., a corporation organized under the laws of Delaware, has both its administrative office and its manufacturing plant in Birmingham, Alabama. It maintains warehouses in 5 states (Alabama, Pennsylvania, Illinois, Texas, and California), sales offices in 7 states (Massachusetts, New York, Georgia, Pennsylvania, California, Texas, and Missouri) and in the District of Columbia, and it ships its products (valves and pipe fittings) to customers in all 49 jurisdictions. It has paid income taxes to Alabama, California, Pennsylvania, and the District of Columbia, but has protested paying an income tax recently imposed on it in Georgia (with arrears and penalties running back to 1952).

Stockham's objection is based on the fact that its sales representative spends only one-third of his time in Georgia, and is employed only in soliciting orders and in promotional work; all orders from Georgia customers are accepted or rejected at the home office in Alabama, and all goods are supplied from the office or factory in Alabama. The company maintains that the imposition of the tax runs afoul of the commerce clause and the due process clause. The Supreme Court of Georgia upheld the company, but the state attorney

general appealed the decision to the Supreme Court of the United States.

Northwestern States Portland Cement Co. has a manufacturing plant in Iowa. It maintains a sales office in Minnesota and sells its products (cement and cement products) in the North Central states. In its Minneapolis office it employs five salesmen and a secretary. The salesmen write orders and do promotional work, but all orders are subject to acceptance at the home office in Iowa and are filled from inventories in Iowa. Minnesota has recently assessed its income tax on the company with arrears and penalties going back to 1933.

The company appealed to the courts on the ground that the tax violated the commerce clause. The Supreme Court of Minnesota, however, ruled against it. Therefore, the company appealed to the Supreme Court of the United States.

Brown-Forman Distillers Corporation is a Kentucky company engaged in the manufacturing and packaging of alcoholic beverages in that state. It receives orders from wholesalers at its home office, where they are accepted or rejected and where, on acceptance, the orders are filled by direct shipments to the wholesaler. The extent of its Louisiana activity is to ship goods into the state and to maintain "missionary men" whose sole activity is occasionally to accompany salesmen of the wholesaler and to seek to persuade retailers to display the company's products prominently.

In 1954 Louisiana demanded payments by the company of the state corporate income tax covering the years 1951 through 1953, and, subsequently, through 1955. The company paid under protest, appealing to the courts on the ground that it did not maintain any stock of goods in Louisiana nor any salesmen in the state, and that the assessment of the tax on it was in

violation of the commerce and due process clauses. The Supreme Court of Louisiana in February 1958 ruled against the company. The company then, in June, submitted a petition to the Supreme Court of the United States for a review.

The decisions of the Supreme Court in these three cases are being anxiously awaited by state tax administrators as well as by many corporations and business organizations throughout the country. Whichever way they go, if definitive, they will have momentous consequences.

Legal Distinctions

In a discussion of this type we can disregard some of the legal distinctions often observed by tax specialists:

> Throughout this article we refer to the corporate income tax as any general tax on corporations that uses net income as a basis for its computation. In legal terminology a distinction is made between the so-called "franchise tax measured by net income" and the "corporate net income tax," not designated as a franchise tax but sometimes referred to as a "direct tax on corporate net income." This distinction is presumed to have important jurisdictional implications. The franchise tax, because it is imposed on the privilege of doing business in the state, is supposed to be more limited by the commerce clause than the direct corporation income tax.[2]

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[2]See George T. Altman and Frank M. Keesling, *Allocation of Income in State Taxation* (New York, Chicago, Commerce Clearing House, 1950), p. 29; Jerome R. Hellerstein, "Recent Developments in Commerce Clause Limitations on State Taxation," *The Tax Executive*, January 1958, pp. 120-121; Fred L. Cox, "Interstate Commerce and a State's Right to Revenue," *Taxes*, January 1952, p. 25; Reuben Clark, Jr., "Interstate Commerce and a State's Right to Revenue: A Rejoinder," *Taxes*, April 1952, p. 263; and Edward Roesken, "The Impact of the Spector Decision," *loc. cit.*

For this reason, some states, including California, Pennsylvania, Minnesota, and Oregon, have in recent years supplemented their corporation franchise tax measured by net income with a direct corporate net income tax. While continuing to apply the first to corporations operating property within the state and carrying on substantive business operations in both intrastate and interstate commerce, they apply the second tax to out-of-state corporations that merely solicit orders and sell goods in the state—in other words, to the group engaged solely in interstate commerce. They specifically identify the latter tax in their statutes as applicable to corporations engaged solely in interstate commerce. The assumption seems to be that through the use of this tax states can bypass the strictures of the commerce clause. The direct corporate net income tax in these states is thus primarily a legal device for taxing the net income of out-of-state corporations.

From an economic point of view, however, there is no difference between the franchise and the non-franchise corporate income taxes. Both of them find their economic justification in the fact that corporations receive certain services from the state which enable them to earn a net income from business done within the state. Therefore, since we are not concerned here with an analysis of legal technicalities in the imposition of corporate income taxes, we shall disregard these differentiations in legal nomenclature and speak of both taxes as "corporate income taxes."

There is another legal distinction in the application of corporate income taxes which is of no great economic importance—namely the distinction between the so-called "domestic" and "foreign" corporations, the first designating those chartered in the state and the second those chartered in other states or in foreign countries. Generally, the corporation income tax is ap-

plied to both types of corporations with no differentiation in base and rate structure.

From an economic point of view, it is unimportant whether a corporation has received its charter in one state or another. The only significant difference is between corporations which own and operate properties in the state and have a definite and permanent business site in it and those which merely solicit orders.

HISTORY & DEVELOPMENT

State taxation of corporations on a net income basis is less than 50 years old. Started in a practicable way by Wisconsin in 1911, it was adopted by Connecticut, New York, Massachusetts, Missouri, and several other states by 1919. By the end of 1929 it was in operation in 16 states, and by the end of 1939 in 32 states and the District of Columbia. It is now in use in 34 states (South Dakota has given it up in the meanwhile, and 3 others have adopted it) as well as in the District of Columbia and Hawaii. New Jersey adopted it in May 1958 to go into effect in 1959. EXHIBIT I gives the list of states using the tax, the years of adoption, and other information about the manner of application of the tax.

Four main reasons lay behind the wide adoption of this tax:

(1) Most of the states found that their earlier levies on personal property, gross receipts, or capital stock of corporations were thoroughly disappointing in their revenue yields, as well as increasingly inequitable and difficult to enforce fully. They found net income to be a far superior basis for taxing corporations.

(2) The states needed new sources of revenue during periods of high business activity to finance their added expenditure responsibilities and during periods

of depression to make up for the decline in the revenue yields of some of their older taxes.

(3) The increasing use of the corporate form of organization in manufacturing and mercantile businesses made the taxation of corporations particularly lucrative. Such taxation was also politically popular with the rank-and-file voter.

(4) The enactment in 1909 of the federal excise tax on the net income of corporations and in 1913 of the federal corporation income tax as a companion to the federal personal income tax gave impetus to the enactment of similar taxes by the states. These federal enactments, first of all, provided a standard definition of corporate net income which any state could use. Then, too, corporations that were subject to the federal tax would now have records and other information which could be used in the computation of state corporate income taxes as well, making the administration of the state taxes and compliance with them much easier.

Theory Behind Tax

The imposition of state corporation income taxes has been justified from the very beginning as a benefit tax. The benefit is presumed to be represented by the various protective and economic services which the state renders to corporations and which help them to operate and to earn a net income. The net income is supposed to bear some measurable relation to those services. It is also supposed to measure the relative benefits received from the state better than any other aspect of the company's organization or operations.

We accept this theory as reasonable and cannot side with those students of the subject who deny any just foundation for the tax and explain its imposition merely in terms of

EXHIBIT I. CHARACTERISTICS OF CORPORATE NET INCOME TAXES OF 34 STATES AND THE DISTRICT OF COLUMBIA

Region and state	Year adopted	Franchise or direct income tax	Present rate	Is federal tax deductible from net income?	Yield — 1956	
					Million dollars	Per cent of total state revenue
New England						
Connecticut	1915	F	3.75%	No	$28.5	13.9%
Massachusetts	1919	F	6.76	No	20.6	5.4
Rhode Island	1947	D	5	No	7.6	12.5
Vermont	1931	F	5	No	1.9	6.0
Middle Atlantic						
New York	1917	F	5.5	No	223.1	15.6
Pennsylvania	1935	F & D	6	No	137.6	19.6
East North Central						
Wisconsin	1911	D	2.7	Yes	50.8	15.4
West North Central						
Iowa	1934	D	3	Yes	3.2	1.4
Kansas	1933	D	3	Yes	4.4	2.8
Minnesota	1933	F & D	7.3	Yes	20.5	7.2
Missouri	1917	D	2	Yes	*	*
North Dakota	1919	D	3.6	Yes	1.2	1.2
South Atlantic						
Delaware	1957	D	5	No	†	†
District of Columbia	1939	F	5	No	7.5	5.8
Georgia	1929	D	4	No	18.5	6.6
Maryland	1937	D	5	No	23.6	9.4
North Carolina	1921	D	6	No	44.1	12.5
South Carolina	1922	D	5	No	16.3	9.2
Virginia	1916	D	5	No	27.9	12.3
East South Central						
Alabama	1933	D	3	Yes	*	*
Kentucky	1936	D	5.7	Yes	11.9	6.9
Mississippi	1924	D	2.6	No	11.8	7.8
Tennessee	1923	F	3.75	No	13.8	5.5
West South Central						

Iowa	1934	D	3	Yes	3.2	1.4
Kansas	1933	D	3	Yes	4.4	2.8
Minnesota	1933	F & D	7.3	Yes	20.5	7.2
Missouri	1917	D	2	Yes	*	*
North Dakota	1919	D	3.6	Yes	1.2	1.2
South Atlantic						
Delaware	1957	D	5	No	†	†
District of Columbia	1939	F	5	No	7.5	5.8
Georgia	1929	D	4	No	18.5	6.6
Maryland	1937	D	5	No	23.6	9.4
North Carolina	1921	D	6	No	44.1	12.5
South Carolina	1922	D	5	No	16.3	9.2
Virginia	1916	D	5	No	27.9	12.3
East South Central						
Alabama	1933	D	3	Yes	*	*
Kentucky	1936	D	5.7	Yes	11.9	6.9
Mississippi	1924	D	2.6	No	11.8	7.8
Tennessee	1923	F	3.75	No	13.8	5.5
West South Central						
Arkansas	1929	D	1.5	No	8.7	7.4
Louisiana	1934	D	4	Yes	*	*
Oklahoma	1931	D	4	Yes	9.8	4.7
Mountain						
Arizona	1933	D	1.5	Yes	8.5	8.5
Colorado	1937	D	5	Yes	6.1	4.2
Idaho	1931	F	8	Yes	3.7	7.7
Montana	1917	F	5	Yes	3.0	6.1
New Mexico	1933	D	2	Yes	*	*
Utah	1931	F	4	Yes	3.7	3.1
Pacific						
Alaska	1949	D	9‡	No	1.0	5.0
California	1929	F & D	4	No	157.3	10.3
Oregon	1929	F & D	6	No	16.4	10.1

* Data not available.

† No collections yet, since tax was just enacted in 1957.

‡ 18% of allocated federal tax, or approximately 9%.

Sources: Federation of Tax Administrators, *State Income Taxes*, Research Report No. 18 (Chicago, 1946) and *Tax Administrators News*, 1957 and 1958; Prentice-Hall, Inc., *State and Local Tax Service* (New York), current issues; and U. S. Bureau of the Census, *Compendium of State Government Finances in 1956* (Washington, Government Printing Office, 1957).

expediency.[3] A tax which has no foundation in justice is confiscation, and we do not think that the state corporate income tax, as generally imposed today, is confiscation.

In accordance with the benefit theory, the originators of the tax postulated two subsidiary principles for its imposition:

(1) The tax should be applied only to corporations operating property and maintaining permanent business establishments in the state.

(2) It should be applied only to that portion of the company's income that may reasonably be attributed to its productive activities in the state.

These theories were further confirmed, amplified, and given prestige by the recommendations made in 1919 by the National Tax Association's Committee on a Model Plan of State and Local Taxation. At that time only a few states had adopted a corporate net income tax, so the committee had an almost virgin field of taxation to deal with. It laid down two principles in its report:

(1) "Business carried on for profit in any locality should be taxed for the benefit it receives."

(2) "[The state tax] should, except in certain cases, be levied upon the net income derived from business carried on within the state levying the tax.'"[4]

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[3] For elaboration of the benefit theory of business taxation, see Paul Studenski, "Toward a Theory of Business Taxation," *Journal of Political Economy*, October 1940, pp. 622-654.

[4] For the committee's report, see National Tax Association, *Proceedings of the Annual Conference* (New York, 1919), pp. 426 ff. For the Model Plan Act, see *The Bulletin of the National Tax Association*, January 1921, pp. 97-125.

(The exceptions stated were those of small enterprises not taxed federally and those "where apportionment of net income from an interstate business is peculiarly difficult." In these cases a tax of a flat amount or one on gross receipts was considered acceptable.)

Allocation Formulas

In 1920 a subsidiary committee was established by the National Tax Association to develop the details of the Model Plan.[5] The committee strongly recommended that only corporations having property in the state or a regular place of business through which orders are negotiated and accepted should be taxed by a state, and that the mere solicitation of sales in the state does not provide a sufficient basis for the imposition of the tax.

In devising the allocation formula for the imposition of the tax, the committee endeavored to reconcile the interests of the manufacturing and the merchandising states. It did not agree with the formula used by Massachusetts, under which one-third weight was given to each of these three factors: location of tangible property, amount of the payroll, and receipts from sales. Nor did it agree with the recommendation of the original committee on the Model Plan, under which two-thirds weight was given to the location of the company's tangible property and only one-third weight to the receipts from sales.

The committee recommended what it called "a middle ground," giving the two factors of property and business equal weight. It urged "that the business factor be measured by the sum of the amounts paid out by the taxpayer for labor and material plus the amount of the receipt from the sale of the goods and products dealt in, including incidental receipts," contending that "business activity is

[5] For the committee's report, see National Tax Association, *Proceedings of the Annual Conference* (New York, 1922), pp. 198-222.

measured both by income and outgo." The proposed formula thus constituted a compromise between the formulas then being used by Wisconsin, New York, and Massachusetts. With regard to the allocation of the business factor, the committee stated:

> "The general principle back of allocating all of these elements would seem to be that *they must be assigned to some regular place of business of the company. A fringe of business activity may extend out to a considerable distance from every place of business. For example: travelers may be sent to other states for the purpose of soliciting orders or making purchases, but for practical purposes no income can be attributed to these outlying points where the customers or parties negotiated with are located. . . . All of the income should be allocated to some place where it is feasible and practicable to tax it; that is, to some place of business of the taxpayer. Any portion of the income allocated to a state where there is no place of business; the only activity being that of travelers, would be practically immune from taxation.*
>
> "From the draft law attached it will be seen that wage and salary payments are to be assigned to the office at which the employee chiefly works or from which he is sent out. Similarly *purchases and sales are assigned to the office at or from which they are chiefly negotiated and executed.* . . . A sale may involve solicitation of the order, acceptance, shipment of goods, carrying an account with the customer on the books, collecting the purchase price and general correspondence with the customer. It seems to the Committee that *no one of these elements is sufficient to outweigh all of the others.* . . ." [Italics added]

The development of state corporate income tax legislation during the succeeding 20 or more years conformed

closely to the position implied by the two committees of the National Tax Association insofar as state jurisdiction to apply the tax was concerned. But it did not follow their recommendations as to a particular uniform allocation formula. Differences in the nature of their economies prompted the states to adopt different formulas, each calculated to produce the largest possible revenue or to suit the particular circumstances best. The danger of unfair double taxation of corporations, therefore, was not prevented.

In fact, in 1939 another committee of the National Tax Association, which was struggling with this same problem of uniformity of allocation, reported 16 different allocation formulas in use by the 32 states then levying corporate income taxes.* These formulas were as follows:

Factors	Number of states using these factors
Property, payroll, sales	10
Property, manufacturing costs, sales	7
Property, sales	8
Sales	8
Property, manufacturing costs	1
Property, cost of sales, sales	1
Property, payroll	2
Property, shares of other corporations, accounts receivable	1
Property, payroll, sales, purchases	1
Property	1
Manufacturing costs	1
Marketing costs	1
Property, payroll, sales, manufacturing costs	1
Costs of sales	1
Property, payroll, purchases	1
Loans, wages, interest	1

The differences in allocation formulas have been even greater than is suggested by the foregoing list, since sales have also been variously defined. In some formulas, sales are identified as receipts at the office in which they are ne-

*National Tax Association, *Proceedings of the Annual Conference* (New York, 1939), p. 193.

gotiated, in others as receipts at the place at which the goods are located, in still others as receipts at the place of the acceptance of orders, in quite a few as receipts at the place from which goods are shipped, and so forth. Moreover, different formulas have sometimes been used in the same state for different types of companies.

OPERATION APPRAISED

Corporation income taxes levied only on firms operating properties in the state, keeping stores of goods there, or maintaining offices there in which orders are accepted have operated fairly well from the point of view of the states, the corporate taxpayers, and the national interest.

Substantial Revenue

The taxes shown in Exhibit 1 returned more than $900 million of revenue to 34 states and the District of Columbia in 1956. More than two-thirds of this revenue was collected by the 10 manufacturing states of New York, California, Pennsylvania, Wisconsin, North Carolina, Connecticut, Virginia, Maryland, Massachusetts, and Minnesota. In each of these 10 states such collections amounted to between 10% and 20% of the entire state tax revenue. In the other 24 states the tax is much less important, providing in some cases only about 1% of the state tax revenue, and in others a maximum of 10%.

The taxes have produced an expanding revenue for the states during periods of high business activity and a diminishing revenue during periods of business contraction. This instability of yields does have certain disadvantages from the point of view of a state, but from a broad national standpoint it is a commendable feature because it helps to stabilize the national economy and to coordinate state fiscal policy with federal fiscal policy toward the achievement of this goal. The unfavorable effect of this instability on a

state's ability to finance its expenditures can be taken care of by the establishment of state revenue stabilization reserves in which surplus revenue would be stored during boom periods and from which money would be withdrawn during periods of depression.

The cost of administering state corporate income taxes has been comparatively low, ranging from about 1% in New York, where an especially large portion of the tax is collected from a small number of large taxpayers and where the structure of the tax is comparatively simple, to 5% in some other states, in which the situation in these respects is less favorable.

Compliance with the taxes, though far from being easy, has been manageable up to now because under the jurisdictional concept used in most states the majority of corporations have had to pay a tax to comparatively few states.[7]

Aggregate Impact

In an effort to ascertain the impact of state corporation income taxes, a questionnaire was addressed to 100 selected manufacturing companies, mostly large and medium-size, and a number of executives of these and other companies were interviewed. The type of information essential to a competent appraisal of the operations of state taxes, but not generally available, was thereby obtained for a number of different companies.

For convenience of illustration 25 companies representing different manufacturing industries and situations were selected for a more detailed analysis; the more important information obtained from them is presented in Exhibits II, III, and IV. It is not claimed that these 25 companies are a completely accurate sample of American manufacturing in-

[7] See Albert H. Cohen, *Apportionment and Allocation Formulae . . .* (New York, Controllership Foundation, Inc., 1954).

dustry affected by state corporation income taxation. For one thing, the group does not contain enough small corporations. However, this should be a fair picture of how a substantial number of manufacturing corporations are affected by state income taxes. The following points are of interest:

As seen from EXHIBIT II, of the 25 companies, 16 have their properties concentrated in 1 to 5 states, 5 in 6 to 10 states, and only 4 have properties in more than 10 states. Moreover, as EXHIBIT III shows, 14 of the 25 have from 90% to 100% of their properties located in a single state, and, on the other hand, only 2 have less than 50% of their properties so located.

The payrolls of these companies are also concentrated in a few states, although not quite to the same degree. Thus, of the 22 companies for which such statistics are available, 12 have from 80% to 100% of the payrolls concentrated in a single state, 6 have from 50% to 80% so concentrated, and only 4 have less than 50% concentrated in any single state.

The sales offices of most of these companies show a fairly high degree of concentration, but less than either plants or payrolls. Of the 25 companies, 12 have sales offices in at most 2 states and do their selling in the others either through resident salesmen or, in most instances, non-resident salesmen. However, 7 have sales offices in 10 or more states.

Contrasted with this substantial concentration of properties and payrolls, and moderate concentration of sales offices in a few states, is the wide dispersion of sales across the national market. It will be noted that 21 of the companies sell goods in *all* of the states and in the District of Columbia, 3 in 38 to 43 states, and only 1 sells in a limited area of 7 states. For the 19

companies for which complete sales data are available, only 3 companies have more than one-quarter of their sales concentrated in a single state. Four companies sell in some states by mail order. One of them uses this method in all areas but its home state.

The concentration of properties, payrolls, and regular sales offices in a few states has up to now considerably limited the susceptibility of the 25 companies to state income taxes. It is not surprising, therefore, to

EXHIBIT II. DISTRIBUTION BY STATES OF PROPERTIES, SALES, AND NET INCOME TAX PAYMENTS OF 25 MANUFACTURING COMPANIES

Company by size* and type of product	Number of states‡ in which the company: Has property (plants, inventories, etc.)	Sells goods	Maintains sales offices	Employs resident salesmen	Employs non-resident salesmen	Pays state net income taxes	Per cent of company's net income subject to state net income taxes
Small							
1. Machinery	1	49	0	19	30	1	100.0%
2. Furniture	1	7	1	0	0	1	100.0
3. Chemical	12	49	16	1	19	4	†
Medium							
4. Tools	3	49	2	10	37	2	101.5
5. Machinery	1	49	0	8	41	2	†
6. Chemical	1	49	1	27	21	2	100.3
7. Leather	2	43	2	1	37	3	62.0
8. Paper	1	38	0	32	4	3	5.1
9. Textiles	5	49	6	7	36	3	69.0
10. Electrical machinery	5	49	7	9	33	2	98.8
11. Tiling	6	40	5	7	28	4	94.9
12. Iron & Steel products	3	49	2	15	32	1	91.4
13. Furniture	1	49	0	21	28	1	100.0
14. Food products	2	49	3	†	†	1	78.8
Large							
15. Nonferrous metals	2	49	10	7	32	1	8.6
16. Writing instruments	1	49	1	27	21	3	5.4
17. Furniture	11	49	5	12	32	8	69.2
18. Electrical machinery	8	49	44	0	5	5	100.5
19. Drugs	38	49	36	0	13	27	62.5
20. Textiles	7	49	12	1	36	7	65.9
21. Apparel	10	49	4	45	0	8	43.4
22. Apparel	2	49	1	15	33	2	85.8
23. Food products	10	49	25	20	4	7	39.0
24. Automobile parts	14	49	16	12	21	10	64.1
25. Apparel	1	49	†	32	16	3	103.2

* Size classifications are: small—annual sales under $2 million and less than 200 employees; medium—annual sales from $2 million to $25 million and from 200 to 1,000 employees; large—annual sales over $25 million and over 1,000 employees.

† Data not available.

‡ Including District of Columbia; excluding Alaska (not a state at time of survey).

Company by size* and type of product	Number of states‡ in which the company: Has property (plants, inventories, etc.)	Sells goods	Maintains sales offices	Employs resident salesmen	Employs non-resident salesmen	Pays state net income taxes	Per cent of company's net income subject to state net income taxes
Small							
1. Machinery	1	49	0	19	30	1	100.0%
2. Furniture	1	7	1	0	0	1	100.0
3. Chemical	12	49	16	1	19	4	†
Medium							
4. Tools	3	49	2	10	37	2	101.5
5. Machinery	1	49	0	8	41	2	†
6. Chemical	1	49	1	27	21	2	100.3
7. Leather	2	43	2	1	37	3	62.0
8. Paper	1	38	0	32	4	3	5.1
9. Textiles	5	49	6	7	36	3	69.0
10. Electrical machinery	5	49	7	9	33	2	98.8
11. Tiling	6	40	5	7	28	4	94.9
12. Iron & Steel products	3	49	2	15	32	1	91.4
13. Furniture	1	49	0	21	28	1	100.0
14. Food products	2	49	3	†	†	1	78.8
Large							
15. Nonferrous metals	2	49	10	7	32	1	8.6
16. Writing instruments	1	49	1	27	21	3	5.4
17. Furniture	11	49	5	12	32	8	69.2
18. Electrical machinery	3	49	44	0	5	5	100.5
19. Drugs	38	49	36	0	13	27	62.5
20. Textiles	7	49	12	1	36	7	65.9
21. Apparel	10	49	4	45	0	8	43.4
22. Apparel	2	49	1	15	33	2	85.8
23. Food products	10	49	25	20	4	7	39.0
24. Automobile parts	14	49	16	12	21	10	64.1
25. Apparel	1	49	1	32	16	3	103.2

* Size classifications are: small—annual sales under $2 million and less than 200 employees; medium—annual sales from $2 million to $25 million and from 200 to 1,000 employees; large—annual sales over $25 million and over 1,000 employees.

† Data not available.

‡ Including District of Columbia; excluding Alaska (not a state at time of survey).

find that 16 firms pay net income taxes in only 1 to 3 states, 3 companies in 4 to 5 states, 4 in 6 to 8 states, 1 in 10 states, and 1, which represents an exceptional situation, pays the tax in a fairly substantial number

EXHIBIT III. DEGREE OF CONCENTRATION OF PROPERTY, PAYROLLS, AND SALES IN 25 MANUFACTURING COMPANIES.

(Maximum percentages in any single state)

Company by size* and type of product	Property	Payroll	Sales
Small			
1. Machinery	100.0%	84.9%	8.1%
2. Furniture	100.0	100.0	70.0
3. Chemical	80.0	90.0	†
Medium			
4. Tools	94.0	96.0	13.7
5. Machinery	100.0	†	†
6. Chemical	100.0	19.0	17.3
7. Leather	87.0	77.0	40.9
8. Paper	100.0	72.4	20.3
9. Textiles	87.0	86.0	16.2
10. Electrical machinery	77.4	89.9	30.2
11. Tiling	95.2	88.9	17.0
12. Iron & steel products	99.5	98.1	21.0
13. Furniture	99.2	†	15.8
14. Food products	98.5	94.3	15.0
Large			
15. Nonferrous metals	100.0	65.7	12.5
16. Writing instruments	100.0	†	9.0
17. Furniture	44.3	44.3	18.1
18. Electrical machinery	87.4	88.6	†
19. Drugs	13.9	16.6	14.9
20. Textiles	62.8	68.4	†
21. Apparel	65.1	56.4	8.2
22. Apparel	98.0	95.3	†
23. Food products	25.1	38.6	8.3
24. Automobile parts	54.0	68.0	20.0
25. Apparel	99.9	92.9	12.5

* See Exhibit II.
† Data not available.

of states. However, 9 firms have been subjected to taxation in 1 or 2 states on the basis of sales solicitation only.

Of the 23 companies for which complete data on state income tax payments are available, 4 are assessed on *more* than 100% of their net income because of divergent and overlapping allocation formulas, and 3 pay on

Company by size* and type of product		Property	Payroll	Sales
Small				
1.	Machinery	100.0%	84.9%	8.1%
2.	Furniture	100.0	100.0	70.0
3.	Chemical	80.0	90.0	†
Medium				
4.	Tools	94.0	96.0	13.7
5.	Machinery	100.0	†	†
6.	Chemical	100.0	19.0	17.3
7.	Leather	87.0	77.0	40.9
8.	Paper	100.0	72.4	20.3
9.	Textiles	87.0	86.0	16.2
10.	Electrical machinery	77.4	89.9	30.2
11.	Tiling	95.2	88.9	17.0
12.	Iron & steel products	99.5	98.1	21.0
13.	Furniture	99.2	†	15.8
14.	Food products	98.5	94.3	15.0
Large				
15.	Nonferrous metals	100.0	65.7	12.5
16.	Writing instruments	100.0	†	9.0
17.	Furniture	44.3	44.3	18.1
18.	Electrical machinery	87.4	88.6	†
19.	Drugs	13.9	16.6	14.9
20.	Textiles	62.8	68.4	†
21.	Apparel	65.1	56.4	8.2
22.	Apparel	98.0	95.3	†
23.	Food products	25.1	38.6	8.3
24.	Automobile parts	54.0	68.0	20.0
25.	Apparel	99.9	92.9	12.5

* See Exhibit II.
† Data not available.

100% of their net income; 11 pay on from 60% to less than 100% of their net income, and 5 pay on less than 60%—3 of these 5 paying on less than 10% of their net income.

It should be remembered, however, that some of the companies own properties and conduct business activities in states which have no corporate income taxes but which tax them on their gross receipts, capital stock, or personal property. The fact that only a small percentage of net income is taxed under all the state corporation income taxes does not necessarily mean that a company is escaping its fair share of taxation. For example, the three companies in our group which pay income taxes on less than 10% of their net income do so because their manufacturing plants and properties are concentrated in states that either do not levy a corporate income tax or that apply it on the basis of a sales-allocation factor alone. These companies are taxed on different bases—and not necessarily lightly—in their home states.

The various data presented in these tables generally substantiate the conclusion advanced above that state corporation income taxes, as applied mostly under the traditional jurisdictional concept, have not resulted in serious double taxation. Although cases of companies being taxed on 150% or more of their net income undoubtedly exist, our limited survey has not brought any to light.

RECENT DEPARTURES

Attempts to depart from the original jurisdictional approach to state corporation income taxation were made by some states in the 1920's and 1930's, but all these early attempts were either declared invalid in the courts or, because they were not enforced, were never challenged. For example:

The Massachusetts excise tax of 1919 was designed to tax the net income of out-of-state corporations maintaining sales offices in the state even though orders solicited through them had to be approved by the home office in another state. The law was immediately challenged in the courts and in 1925 was held void by the Supreme Court of the United States on the ground that it violated both the commerce clause and the due process clause.[8]

Postwar Trend

It was only after World War II that the trend away from the original method of application of the tax became pronounced. For example:

After Minnesota enacted a law in 1933 making its income tax on corporations applicable to firms whose business within the state consisted "exclusively of interstate commerce," and added amendments to the statute in 1937 and 1945, it began to apply its tax to out-of-state corporations engaged exclusively in the solicitation of orders in the state. One outgrowth of this enforcement has been the case of *State of Minnesota* v. *Northwestern States Portland Cement Co.*, now before the U. S. Supreme Court, in which the constitutionality of this law is at issue. (The substance of the case was outlined earlier in the article.)

California supplemented its corporate franchise tax in 1937 with a direct corporate tax on income derived "from any activities carried on in this State, regardless of whether carried on in intrastate, interstate or foreign commerce." The California Supreme Court up-

[8] *Alpha Portland Cement Company* v. *Commonwealth of Massachusetts*, 268 U. S. 203. See also Harold S. Lyon, "State Taxation of Foreign Corporations Engaged in Interstate Commerce," *The Bulletin of the National Tax Association*, February 1925, p. 137.

held the law in 1946, and, on an appeal that same year, the Supreme Court of the United States upheld it, too, but without writing an opinion.[9] Following this favorable decision, the state applied its direct corporate income tax to out-of-state corporations that engaged only in interstate commerce and merely solicited orders within the state.

After World War II, several states amended their existing corporate income tax laws or re-interpreted them to apply these taxes on the same broad basis as California. Among them were Arkansas and Colorado, in 1947; Georgia, Pennsylvania, and Connecticut, in 1950 and 1951; and Arizona, in 1954. Pennsylvania's action was stopped in 1956 by a decision of the highest court of the state, which invalidated this type of taxation on constitutional grounds,[10] but the new taxes are now being collected in a determined way by Minnesota, California, Oregon, Georgia, and Louisiana. Several other states, including Vermont and Mississippi, currently are following this lead.

Various factors seem to have been responsible for this postwar trend. First of all, the states have found themselves increasingly cramped in their taxing powers by the recent heavy concentration of taxation on the federal level. Secondly, the so-called market states are increasingly begrudging of the large amounts of revenue that the more industrialized states obtain from corporate net income taxes. Finally, some states with a growing manufacturing economy have sought to lighten the tax burden on their own companies by applying their taxes to out-of-state corporations, and hope that in this way they will induce others to establish permanent manufacturing operations in the states.

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[9] *West Publishing Company* v. *McColgan*, 328 U. S. 823.

[10] *Pennsylvania* v. *Eastman Kodak Co.*, 385 Pa. 607; 124 A. 2d 100.

While thus extending the jurisdictional basis of their corporate net income taxes, the states in question have also been changing their allocation formulas by substituting sales-by-destination or sales-by-site-of-solicitation for sales processed at the home or regional offices of the company, or for other traditional definitions of sales. This change in the allocation formula was necessary in order to ensure to the states the full benefit of the extension of the jurisdictional basis of their corporate income taxes.

Even states that have not extended the jurisdictional basis have started to change their allocation formulas in this way. Some of them—North Carolina and South Carolina, for example—have shifted to the sales-by-destination factor in order to lower the burdens of net income taxes on local firms producing mostly for sale in other states. They have deliberately sacrificed revenue to attract more companies to locate manufacturing plants in their areas.

In recent years many corporations have come to favor the shift to the sales-by-destination factor in the allocation formulas, while opposing the extension of state corporate income taxes to out-of-state corporations engaged exclusively in interstate commerce and in solicitation of orders in the state. They seem to favor this allocation factor because of an expectation that their own state corporate income taxes would then be reduced.

Will this expectation be realized? Only if the traditional jurisdictional basis of the taxes is retained. It will *not* be realized if the states are permitted to tax out-of-state corporations that engage solely in interstate business and in solicitation. For example:

> If subject only to New York taxes, manufacturing corporations maintaining their home offices and inven-

tories in the Empire State would be paying less under the sales-by-destination criterion than they are now paying under the sales-by-origin-of-shipments criterion, while at the same time in those states in which they merely solicit orders and sell goods they would not be paying any corporate income taxes. But if this jurisdictional basis were changed, and New York corporations became subject also to income taxes in the states where they sell goods, they undoubtedly would be paying even *more* than they are now.

It is quite clear that New York will not shift to the sales-by-destination basis, since it would stand to lose as much as $20 million in tax revenue. If it should continue to levy its corporate income tax on a sales-by-origin-of-shipments basis while other states tax the income of New York's corporations on a sales-by-destination basis, these firms will be paying double taxes on the same amount of income. This fact is generally overlooked by those New York corporations that readily endorse the sales-by-destination factor.

In recent years the states and corporations which favor the sales-by-destination factor have been attempting to get those national associations which have long advocated uniform allocation formulas (particularly the National Tax Association) to incorporate the sales-by-destination concept in their recommendations in place of more traditional views. Thus, in 1939 the National Tax Association's Committee on the Allocation of Income, under the chairmanship of Leo Mattersdorf, recommended the partial use of the sales-by-destination factor,[11] and in 1951 a similar committee, under the chairmanship of Jack Miller, recommended a fuller use of this factor.[12] In 1957 a committee of the National Con-

[11] National Tax Association, *Proceedings of the Annual Conference* (New York, 1939), pp. 190-236.

[12] National Tax Association, *Proceedings of the Annual Conference* (New York, 1951), pp. 451-465.

ference of Commissioners on Uniform State Laws drew up a "Uniform Division of Income for Tax Purposes Act" for adoption by the various states, which incorporated the sales-by-destination factor in its apportionment formula.

FALLACIOUS ARGUMENTS

The contention that a state has a rightful claim to tax out-of-state corporations which own no property in the state and carry on none of their productive activities in it, but which merely solicit orders and ship goods to customers, rests on a very weak, if not nonexistent, principle of equity. Indeed, taxation of this kind seems to be largely no more than the reaching out by some states into the fiscal resources of other states:

> States that are primarily markets rather than suppliers will be diverting to themselves for taxation purposes a portion of the corporate income belonging to states which are primarily producers.
>
> States whose enterprises are less efficient and earn less net income will be raising revenue through the taxation of the more efficient and successful enterprises of other states.
>
> States that render fewer services to their home enterprises and are less efficiently governed will be reaping the fruits of the more bountiful services rendered by the other states to their home companies.

It is difficult to conceive how the nation's economy can possibly gain from such haphazard transfers of revenue resources from economically more efficient and better managed states to economically less efficient and more poorly managed ones. It seems much more likely that the national economy will lose from such a reshuffling of state revenue resources. Note that this is quite a different matter from the redistribution of revenue resources accomplished by the federal government when it concentrates its taxation in the

more prosperous states and grants aid to the poorer ones for the maintenance of certain minimum standards of social services. Such a redistribution is controlled and is undertaken with a purposeful eye toward the national benefit.

One of the apparent purposes of the extension of state corporate income taxes to out-of-state corporations which merely solicit orders in the state and of the shift to the sales-by-destination factor is to soften the income tax burden on home companies, thereby inducing home companies to remain in the state and outside companies to relocate or open branches there. But are such reductions in taxation really great enough to produce the intended results? Even if the tax inducements are effective, it is not at all certain that the resultant relocations of industry would increase the efficiency or profits of the companies involved. Moreover, if every state were to offer these inducements, none would get the advantage, and practically every one would lose revenue.

One of the main arguments advanced in favor of the extension of these new taxes is that they help to equalize the tax burdens between home companies and out-of-state companies. It is argued that the traditional jurisdictional basis places home companies at a competitive disadvantage because the state taxes which they must pay are not applied to their out-of-state competitors.

To be sure, a competitor may manufacture in a state with very low taxes. Theoretically it is possible for a sizable differential to exist. But as a practical matter this argument lacks force. The great majority of companies in interstate commerce compete with firms which must pay similar taxes. Take the states accounting for most industrial activity, and you will find unimpressive differentials in the aggregate impact of each government's taxes on companies under its jurisdiction.

Moreover, even where a competitive disadvantage does

exist, it in itself would not be sufficient to justify the imposition of a tax on the out-of-state companies. To warrant this imposition, the state must be able to demonstrate that it furnishes the same services to the out-of-state companies that it does to its own. Otherwise it would violate the rules of economic equity and of constitutional law.

RESULTING PROBLEMS

Not only are there many fallacies in the thinking behind the new tax trend, but there are also many problems which arise. The corporation will have difficulty in complying with the new regulations, while the state will have trouble in administering them. In addition, the taxes may interfere with interstate commerce, thus weakening the national economy.

Difficulties for Business

The new philosophy would operate to make all companies engaged in interstate commerce subject to income taxation in many more states than they are today. As Exhibit IV shows, of the 25 companies covered by this survey only 5 pay corporate income taxes in more than 5 states on the traditional jurisdictional basis. But under the rule which the Supreme Court is being asked to approve, the number of states to which these 25 companies would have to pay income taxes would be increased as follows:

If the taxes are applied to sales offices soliciting orders, 9 out of 25 will pay them to more than 5 states.

If the taxes are applied to the maintenance of resident salesmen, 22 out of the 25 will pay them to more than 5 states.

If the taxes apply to the employment of non-resident salesmen, 24 out of the 25 will pay them to more than 5 states.

The average number of states to which a company would have to pay these taxes would be doubled in the first case,

EXHIBIT IV. NUMBER OF STATES IN WHICH 25 MANUFACTURING CORPORATIONS WOULD BE SUSCEPTIBLE TO NET INCOME TAXES UNDER DIFFERENT JURISDICTIONAL CONCEPTS

Company by size* and type of product	Number of taxing states			
	On traditional basis	Based also on location of sales offices	Based also on location of resident salesmen	Based also on activities of nonresident salesmen
Small				
1. Machinery	1	1	15	34
2. Furniture	1	1	1	1
3. Chemical	4	11	11	30
Medium				
4 Tools	2	2	7	33
5. Machinery	1	1	6	34
6. Chemical	1	1	19	34
7. Leather	2	3	4	34
8. Paper	3	3	23	26
9. Textiles	3	3	6	34
10. Electrical machinery	3	5	6	34
11. Tiling	4	4	7	28
12. Iron & steel products	1	2	11	34
13. Furniture	1	1	14	34
14. Food products	1	3	†	34
Large				
15. Nonferrous metals	1	7	12	34
16. Writing instruments	3	3	34	34
17. Furniture	8	10	12	34
18. Electrical machinery	3	32	32	34
19. Drugs	27	27	27	34
20. Textiles	5	13	13	34
21. Apparel	6	6	34	34
22. Apparel	2	3	13	34
23. Food products	7	25	34	34
24. Automobile parts	10	14	18	34
25. Apparel	1	2	23	34

* Size classifications are: small—annual sales under $2 million and less than 200 employees; medium—annual sales from $2 million to $25 million and from 200 to 1,000 employees; large—annual sales over $25 million and over 1,000 employees.

† Data not available.

quadrupled in the second, and increased eightfold in the third case. In the last case all but one firm (which sells outside its home state on a mail order basis only) would be paying these taxes in more than 26 states.

Difficulties of Compliance

This radical expansion in the number of states in which companies would have to file income tax returns and pay

Company by size* and type of product	Number of taxing states			
	On traditional basis	Based also on location of sales offices	Based also on location of resident salesman	Based also on activities of nonresident salesmen
Small				
1. Machinery	1	1	15	34
2. Furniture	1	1	1	1
3. Chemical	4	11	11	30
Medium				
4 Tools	2	2	7	33
5. Machinery	1	1	6	34
6. Chemical	1	1	19	34
7. Leather	2	3	4	34
8. Paper	3	3	23	26
9. Textiles	3	3	6	34
10. Electrical machinery	3	5	6	34
11. Tiling	4	4	7	28
12. Iron & steel products	1	2	11	34
13. Furniture	1	1	14	34
14. Food products	1	3	†	34
Large				
15. Nonferrous metals	1	7	12	34
16. Writing instruments	3	3	34	34
17. Furniture	8	10	12	34
18. Electrical machinery	3	32	32	34
19. Drugs	27	27	27	34
20. Textiles	5	13	13	34
21. Apparel	6	6	34	34
22. Apparel	2	3	13	34
23. Food products	7	25	34	34
24. Automobile parts	10	14	18	34
25. Apparel	1	2	23	34

* Size classifications are: small—annual sales under $2 million and less than 200 employees; medium—annual sales from $2 million to $25 million and from 200 to 1,000 employees; large—annual sales over $25 million and over 1,000 employees.

† Data not available.

corporate income taxes each year would greatly increase the difficulties and costs of compliance for all those companies that are extensively engaged in interstate commerce. Compliance with 30 or more state corporate income tax laws, each differing in its basis of imposition and allocation of income, might not be too difficult or costly for large corporations that maintain substantial permanent staffs of trained tax accountants and tax lawyers. But it would be a substantial burden for the small and medium-size corporations that would have to hire outside help.

In the course of this survey several tax accounting firms have been asked whether they have been called on recently to prepare state corporation income tax returns in cases where the tax was assessed solely on the ground that a company solicited orders in the state. If they did prepare such returns, they were further asked to specify the amounts of the taxes involved and also the charges made to the clients for the work performed. The replies indicated that some accounting firms had a number of such cases and that the charges for the preparation of some of these returns exceeded by a wide margin the amounts of the taxes involved. Here is what one such firm had to report:

> "We have three fairly typical situations. These three corporations are of medium size, three to four million dollar sales volume per year, and are currently complying with state tax requirements similar to those [mentioned]. Their only activity within the taxing state is a salesman employee who solicits orders.
>
> "Corporation A has complied with the particular state's requirements for three years. The average tax paid is approximately $75. The average cost to properly prepare complete tax returns is approximately $150 per return.
>
> "Corporation B has complied for six years. In this case the average tax amounts to under $20. This ex-

tremely low figure is partially the result of two loss years with no minimum filing fee. The average cost to properly prepare these complete tax returns is also approximately $150.

"In both cases A and B above, no attempt has been made to file returns for years prior to the date of initial compliance.

"Corporation C has filed twelve such returns with an average tax of $46. In this case after complying with the particular state's request, the corporation filed eight returns at one time covering prior years. These eight returns were in skeleton form with many of the required schedules and computations omitted. Therefore, the average cost per return in this case is approximately $100."

Compliance is often not limited to the mere filing of a return, and extensive records must be kept for allocation purposes. Additional information must also be presented to the tax examiners in subsequent return audits and adjustment negotiations. Furthermore, expensive litigation with the states may sometimes be involved, and the possibilities for the harassment of the corporate taxpayer under these broadened applications of state net income taxation will be increased greatly.

Such a vast rise in the number of states to which corporations would have to pay corporate income taxes would greatly increase the possibility of double and multiple taxation of corporations, since the different states undoubtedly would continue to use different allocation formulas. It is exceedingly unlikely that in the years to come the states will be able to achieve much uniformity in allocation when they have failed to do so in the past. In other words, if we follow the newly projected course, we will be multiplying the cases of double taxation instead of limiting them.

As stressed earlier, the only barrier to double and multiple taxation in the development of state corporate income taxation so far has been the traditional jurisdictional basis of its application. The removal of this guard can only result in more numerous and far harsher instances of unfair double taxation.

Costs of Administration

The difficulties of administering state corporate income taxes will also be greatly increased under the new mode of application. It is difficult enough for state tax administrators to secure complete compliance under the traditional jurisdictional basis from the multitude of large and small corporations regularly operating in their state. These difficulties would be multiplied tremendously if the taxes had to be applied to an even larger number of out-of-state corporations that solicit orders in and ship goods to the state. It has been estimated by one tax administrator that he would have to employ 5,000 people to police the enforcement of the corporate income tax on the multitude of out-of-state corporations, small and large, shipping their goods into the state on orders received through agents. This would be many times the number now employed by his department for the enforcement of *all* the state's taxes.

Undoubtedly most of the states extending their income taxes to such out-of-state corporations would find complete enforcement much too expensive and administratively impractical. They would tend to limit the application of the tax in administrative practice, if not in the wording of their laws, to the bigger corporations where the amount obtained would be large enough to justify the effort. Tracking down in-state sales of the smaller out-of-state corporations is a time-consuming task and defies systematic effort even at that. It necessitates inquiries among the dealers who purchase goods, examination of advertising in newspapers, searches through telephone books, and other devices

calling for special detection abilities. In most cases tax administrators would find their efforts unrewarding.

The experience of the several states that have recently adopted the new concept fully confirms this conclusion. Their practice has been to concentrate on the larger out-of-state companies and to let the others alone. Thus, for example, under its direct net income tax California taxes only about 1,000 out-of-state corporations, collecting from them an average of $650 per taxpayer.[13] There are undoubtedly many more out-of-state corporations to which the tax could be applied if the letter of the law were followed.

None of these states has so far legally exempted small out-of-state corporations from the application of the tax, and it is doubtful that a state could constitutionally establish such an exemption without making it equally applicable to its home companies. Furthermore, the administration of the exemption would be quite difficult. Under the circumstances, tax administrators would have to exercise considerable discretion in applying their state's tax to some out-of-state corporations and in not applying it to others.

It is clear, therefore, that the new mode of application of state corporate net income taxes can be only arbitrarily administered, and that many out-of-state corporations will be operating under continuous uncertainty about their vulnerability to a tax assessment and to payments of arrears and penalties. The scope for both bargaining and litigation would be tremendously increased.

Effect of Interstate Commerce

The new concept will also interfere seriously with the free flow of interstate commerce upon which the prosperity of our economy is founded. The imposition of the tax in a

[13] State of California Franchise Tax Board, *Annual Report 1956* (Sacramento), p. 81.

market state is equivalent to a requirement that the corporation take out a license for a right to sell goods in the state. While it may not stop a large corporation from selling goods in the state, it may stop many medium-size or small corporations from doing so. The sales solicited by such a corporation may not be large enough to justify paying a tax and filing a return or to risk back assessments for the years when the company may have been selling goods in the state under the assumption that it was not subject to the tax.

As a result, many corporations may very well limit their sales to a regional rather than a national market, with a consequent curtailment of interregional competition and of the efficient interregional use of the country's economic resources. A good part of the unity of our national market would be destroyed for the first time in the history of our country. Actually, in the whole 170 years that have elapsed since the adoption of the federal constitution—which prohibited the erection of tariff barriers by the states and established one single national market—there has not been a comparable attempt at interference with interstate commerce.

The whole structure of distribution of manufactured goods may be changed fundamentally, but not advantageously, as a result of these interferences with interstate commerce, since many corporations may organize subsidiaries, dispense with sales agents, or sell through distributors to avoid the harassing state impositions. In this way the efficiency of the national economy would be reduced.

The company executives interviewed or otherwise contacted in the course of this study expressed grave concern over the adverse effects which wider use of this innovation in state business taxation might have on their ability to carry on business throughout the country. Quite a number of companies indicated that they would seriously consider making substantial alterations in their whole sales organi-

zations and activities if taxed on such a basis. Medium-size and small concerns were particularly emphatic in this respect. The following are representative samples of responses to our questionnaire:

"We might well have to abandon or drastically change our sales methods. Possibly we would try to work through sales agencies or sell direct without a sales force. Taxation of income by the various states and a duplication of such taxation by our home state would be financially intolerable."

"We would sell to some organization in that state for resale by them to users and endeavor to have all sales qualify as interstate commerce sales."

"If such states were far removed from our plant, we might possibly withdraw from doing business in them, because of this additional cost on top of high freight equalization costs."

"We might have to consider other channels of distribution."

"We would try to sell more locally and cut out other states."

"Records by states would have to be kept for the first time—they would act as a deterrent in marginal profit states."

"It would cause us to examine the value of states from a sales and profit standpoint and perhaps stop sale in certain marginal states."

CONCLUSION

From an economic point of view it must be concluded that the application of corporate income taxes by states to

firms which merely solicit business in the state, whether through a local office, a resident salesman operating from his home, or nonresident traveling salesmen, is unwise. The reasons are as follows:

(1) Where an out-of-state company's activities are confined to solicitation, its contact with the state is too remote and its receipt of benefits from the state, if any, are too inconsequential to consider it an integral part of that state's economy and to justify, on any principle of equity, any levy as direct and pervasive as the net income tax.

(2) Companies that are extensively engaged in interstate commerce will have to file annual returns and pay income taxes to a multitude of states in which they conduct very little business. This will increase the difficulties of compliance because of the different methods used by the states in imposing these taxes and in allocating income under them. It will compel many corporations, especially of small and medium size, to restrict their sales to a few states, with the result that interstate commerce will be impeded and the efficiency of the national economy will be lowered.

(3) The possibilities of double and multiple taxation of companies on the same net income will be greatly increased. Thus, that degree of relative equitableness which it has taken the states many years to achieve will be destroyed.

(4) Levying income taxes on such companies represents the taxing by some states of income produced by the capital and labor employed in other states with the aid of the services rendered by these other states. This constitutes an uncontrolled and often wholly unwarranted redistribution of tax resources not calculated to produce any discernible national advantage.

(5) Finally, the administration of these taxes will be much more difficult and arbitrary, and will necessarily result in a considerable amount of evasion and litigation.

Companies not directly engaged in manufacturing in a state should be required to pay taxes there on a net income basis only if they maintain regular and permanent administrative and sales offices authoritatively representing them, and if they conduct more extensive and direct business operations through these offices than the mere solicitation of orders. Such operations may include different functions in different types of companies. They may embrace the adjustment and collection of accounts, the care of customers' complaints, the servicing of the company's installations, the display of goods for sale, the definite acceptance of orders and filling them from stocks on hand, the sending out of salesmen to surrounding states, and so on. How many such activities would have to be conducted to make a company vulnerable to taxation on this basis is a question that may well be left to each state to decide for itself.

Future Action

It is to be hoped, therefore, that after considering the effects of the new tax on business and the economy, the states that have attempted to apply it will abandon it; that other states will desist from attempting it; and that the national associations that have been striving for years to promote equitable and sound methods of state and local business taxation will withhold endorsement from this dangerous new concept.

It is to be hoped, too, from an economic point of view, that the Supreme Court will find the mere solicitation of orders in a state an insufficient basis for imposing a state corporate income tax, and rule that any levy made on that basis is in violation of both the commerce clause and the due process clause.

Finally, it is to be hoped that Congress will bar the unwise and nationally harmful extension of state corporation income taxation into the domain of interstate commerce. These bars must be specific enough to prevent harmful state action and yet be broad enough to allow the states legitimate latitude in shaping their business income taxes according to their particular circumstances. No matter how the Supreme Court decides the constitutional issues involved, economic considerations make Congressional intervention of this kind absolutely necessary.

Exactly what form such federal legislation should take is a question that cannot be answered without a broad and competent study of all the issues and facts involved. Congress alone can make such a study, and it should organize one soon.